DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 04-0149
Use Tax—Mining Exemption
Penalty—Request for Waiver
For Tax Years 2000, 2001, 2002

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ISSUES

I. Use Tax—Mining exemption

Authority: IC § 6-8.1-5-1(b); IC § 6-2.5-2-1; IC § 6-2.5-3-2 through IC § 6-2.5-3-7; IC § 6-2.5-5-3(b); 45 IAC 15-5-3(8); 45 IAC 2.2-2-1; 45 IAC 2.2-3-4; 45 IAC 2.2-3-8; 45 IAC 2.2-3-12(c); 45 IAC 2.2-4-26; 45 IAC 2.2-5-9; 45 IAC 2.2-5-12(f)

Taxpayer protests the assessment of use tax on purchases of tangible personal property used in fulfilling construction contracts, arguing that it is entitled to a "pass-through" mining exemption.

II. Penalty—Request for waiver

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the 10% negligence penalty and requests a waiver.

STATEMENT OF FACTS

Taxpayer's principal business activity is that of a land development contractor making improvements to realty on land taxpayer does not own. Contracted-for work performed by taxpayer includes clearing land, moving and excavating earth, installing water and sewage lines, constructing roads and highways, improving ditches and drainages, and preparing building sites. Taxpayer has also contracted with mining companies for box cut excavations, creating access from the top of the cut to the underground mine entrance. In connection with contract work for mining companies, taxpayer constructs slurry ponds and coarse refuse pits, rail spur lines and bridges, and coal load-out site improvements. Under some contracts, taxpayer would subcontract work that was outside its area of expertise to more specialized companies, such as concrete construction, asphalt paving, building construction, commercial landscaping and rock blasting.

The audit determined that pursuant to 45 IAC 2.2-3-7, 45 IAC 2.2-3-8, and 45 IAC 2.2-4-26, taxpayer was liable for use tax on materials used in performing its contracts where sales tax was not paid at the point of purchase. Taxpayer protested the use tax assessment and 10% negligence penalty, arguing that because of the way these particular jobs were performed, taxpayer should be allowed a "pass-through" exemption from the mining companies to them, based on an agent-principal relationship. More facts will be added as necessary.

I. Use Tax—Mining Exemption

DISCUSSION

According to taxpayer, during the tax years at issue, taxpayer's company and two others, all three equally owned by taxpayer and his three brothers, entered into an unusual "contract." According to the sworn affidavits submitted in support of taxpayer's protest, the president of the two mining companies, pursuant to the "informal mutual consent of my other brothers . . . orally authorized" taxpayer to develop coal mines for the mining companies. The development began in 2000 and continued through 2002. Expenditures were in excess of $15.25 million dollars. The "parties" allege that this informal, oral contract was "[c]ontrary to normal company job bid procedures . . . industry standard operating procedure and company operating procedure" because there was no competitive public bid and no written contracts. Essentially, the president of the two mining companies alleges that "[a]t all times during the mine development process, [taxpayer] was operating under the direction and control of" the two mining companies. It is the informal nature of this "contract" that gives rise to taxpayer's agent-principal/pass-through exemption argument, and that it should not be held liable for the use tax assessment and 10% negligence penalty.

Pursuant to IC § 6-8.1-5-1(b) and 45 IAC 15-5-3(8), a "notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the assessment is made." Pursuant to IC § 6-2.5-2-1, a "person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state." *See also*, 45 IAC 2.2-2-1. Pursuant to IC §§ 6-2.5-3-2 through 6-2.5-3-7, an "excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction." An exemption is provided in IC § 6-2.5-3-4 if "the property was acquired in a retail transaction and the state gross retail tax" was paid at the time of purchase. Taxpayers are personally liable for the tax. (IC § 6-2.5-3-6). IC § 6-2.5-3-7 provides that a "person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana;" therefore, the presumption of taxability exists until rebutted. *See also*, 45 IAC 2.2-3-4.

The specific statute at issue, IC § 6-2.5-5-3(b) provides an exemption from the state's gross retail and use taxes under certain circumstances:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring the property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Taxpayer maintains that because of its principal/agent relationship with the mining companies, it is entitled to the mining exemption and therefore should not be assessed use tax on items purchased without paying the state's gross retail tax. The specific regulation at issue, 45 IAC 2.2-5-9, sets forth, at great length, exactly how—and when—the exemption applies:

> (a) In general, all purchases of tangible personal property by persons engaged in extraction or mining are taxable. The exemption provided in this regulation extends only to manufacturing machinery, tools, and equipment directly used in mining or extraction. It does not apply to materials consumed in mining or extraction.
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> (b) The state gross retail tax shall not apply to sales of manufacturing machinery, tools, and equipment which are to be directly used by the purchaser in extraction or mining.
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> (c) Manufacturing machinery, tools, and equipment to be directly used by the purchaser in the extraction or mining process are exempt from tax provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the item being produced by mining or extraction. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
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> (d) Pre-production and post-production activities. "Direct use in the extraction and mining process" begins at the point of the first operation or activity constituting part of the integrated production process." {sic} Utilization by the purchaser in extraction or mining begins with the first drilling of the shaft or well or the first removal of overburden in surface mining or quarrying. It ends when the item being mined or extracted has been physically removed from the mine, well, or quarry.
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> (e) Equipment directly used in extraction or mining: Manufacturing machinery, tools, and equipment used directly in the mining or extraction process are taxable unless the machinery, tools, and equipment have an immediate effect upon mining or extracting the product. The fact that particular property may be considered essential to the conduct of the business of mining because its use is required either by law or practical necessity does not, of itself, mean that the property has an immediate effect upon the mining or extracting of the product. Instead, in addition to being essential for one of the above reason *[sic]*, the property must also be an integral part of an integrated process.
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> (1) Examples of taxable machinery, tools, and equipment: transportation equipment used to convey fuel, supplies, and repair parts to coal mining equipment in the mine; field

maintenance trucks used to transport men and materials to places where needed; and equipment used to load extracted and processed minerals from storage stockpiles to railroad cars.

(2) Examples of exempt machinery, tools, and equipment: digging and extracting equipment used in the course of mining or extraction operations; machinery used to remove the overburden in surface mining; blasting and dislodging equipment; waste extraction and removal equipment and machinery used in the course of mining or extraction operations; derricks, pumps, pump houses, drilling rigs used in the production of oil and natural gas.

(f) Storage equipment. Tangible personal property used in or for the purpose of storing raw materials or materials after completion of the extraction or mining process is taxable.

(1) Temporary storage. Tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold.

(2) Storage containers for finished goods after the completion of the extraction or mining process are subject to tax.

(A) Receiving tanks for natural gas, crude oil, or brine are taxable.

(B) Facilities for storing coal after extraction and processing from the mine are taxable.

(3) Storage facilities or containers for materials or items currently undergoing production during the production process are deemed temporary storage facilities and containers and are not subject to tax.

(g) Transportation equipment. Transportation equipment used in mining or extraction is taxable unless it is directly used in the mining or extraction process.

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials within the extraction or mining process is not subject to tax.

(4) Transportation equipment used to transport work–in-process, semi-finished, or finished goods between plants which are not part of the same integrated process is taxable.

(h) Maintenance and replacement.

(1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery and equipment used predominantly in mining or extraction are subject to tax.
(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, however, are exempt from tax.

(i) Testing and inspection.

(1) Machinery, tools, and equipment used to test or inspect the mineral, oil, gas, stone, etc., being mined or extracted is not taxable, as such machinery, tools, and equipment are directly used in the mining or extraction process.
(2) Testing or inspection equipment used to test or inspect machinery, tools, and equipment used in extraction or mining (as distinguished from testing or inspecting the mineral, oil, gas, stone, etc., being mined or extracted) is taxable.

See also, 45 IAC 2.2-3-8, 45 IAC 2.2-4-26, and Information Bulletin # 60, December 2002. Indiana's tax statutes and regulations, especially those governing contractors, all support the taxability of taxpayer's purchases of tangible personal property used or consumed in performing the "informal contract" with the mining companies, regardless of that informality, and regardless of the exempt status of the mining companies. *See*, IAC 2.2-3-12(c) and 45 IAC 2.2-5-12(f) for "other taxable transactions."

The specific assessments taxpayer is protesting are detour signs; fuel; blasting materials and labor supplied by a subcontractor where taxpayer states the mining company reimbursed taxpayer for those expenditures used to excavate box cuts. Taxpayer alleges the detour signs were used in government construction contracts for public roads. Taxpayer cited Sales Tax Information Bulletin # 60 (December 2002) in support. This Bulletin supports the general rule of taxability and cites 45 IAC 2.2-3-12(c) as further support for the taxability of tangible personal property such as detour signs. Information Bulletin #60, however, provides that the purchase, lease or use of such items must be "to comply with the requirements of a government construction contract…, provided the item is used solely in connection with the construction and/or repair of public roads…and is not used for any other purpose." Taxpayer has failed to establish that its purchase of the detour signs qualifies for exemption under the requirements of Information Bulletin #60. Therefore, the protest concerning detour signs is denied.

With respect to the tax assessed on fuel consumption, the audit found that the fuel "was consumed in administrative or transport vehicles" and for "off-road consumption in excavation or grading heavy equipment." Taxpayer argued that since the mining company was "an organization exempt from tax" under 45 IAC 2.2-4-26(c), that exemption should "pass through" to taxpayer and therefore no tax would be due on these fuel purchases. Since no such "pass through" exemption exists, and since the mining company, in all likelihood, could not have avoided tax liability on fuel consumed in activities not directly related to direct production of coal, taxpayer's protest on this issue must be denied.

Finally, taxpayer again argues that 45 IAC 2.2-4-26(c) insulates it from tax liability for the purchase of blasting materials and labor used to excavate box cuts, a pre-production activity. In all likelihood, the mining company could not have purchased said materials and labor exempt from tax; therefore, even if there were such a thing as a "pass through" exemption, there would be nothing to pass on. Therefore, taxpayer's protest must be denied.

FINDING

Taxpayer's protest concerning the assessment of use tax on purchases of tangible personal property used in fulfilling construction contracts, based on the theory of a "pass through" mining exemption, is denied.

II. Penalty—Request for waiver

DISCUSSION

Taxpayer protests the imposition of the 10% negligence penalty. Taxpayer argues that it had reasonable cause for failing to pay the appropriate amount of tax due because it reasonably believed it was entitled to mining exemptions for the purchases at issue.

Indiana Code Section 6-8.1-10-2.1(d) states that if a taxpayer subject to the negligence penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit taxes held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. Indiana Administrative Code, Title 45, Rule 15, section 11-2 defines negligence as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by Indiana's tax statutes and administrative regulations.

In order for the Department to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying or failing to carry out a duty giving rise to the penalty imposed. . . ." In determining whether reasonable cause existed, the Department may consider the nature of the tax involved previous judicial precedents, previous department instructions, and previous audits.

Taxpayer has not set forth a basis whereby the Department could conclude taxpayer exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Therefore, given the totality of all the circumstances, waiver of the penalty is not appropriate in this particular instance.

FINDING

Taxpayer's protest concerning the proposed imposition of the 10% negligence penalty is denied.

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